INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Area Director, Field Compliance, SBSE

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Year Involved:
Date of Conference:

LEGEND:

Employer =
Employee A =
Employee B =
Year 1 =
State =
Y =

ISSUES:

1. Are payments made by the Employer to two former employees (Employee A and Employee B) pursuant to settlement agreements whereby both employees agreed to release their employment discrimination claims against the Employer subject to Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) taxes, and income tax withholding where the parties agreed to allocate a portion of the payment to emotional distress?

2. In the settlement agreement relating to Employee B's claim, is the portion of the settlement payment allocated to attorney's fees and paid by the Employer directly to Employee B's attorney includable in Employee B's income and subject to FICA, FUTA, and income tax withholding?

CONCLUSIONS:

1. In the settlement agreement relating to Employee A's claim, the allocation of one-half of the settlement payments to emotional distress is reasonable and consistent with the underlying realities of the claim and therefore, the portion of the settlement payment so allocated is not subject to FICA, FUTA and income tax withholding. In the settlement agreement relating to Employee B's claim, the allocation of two-thirds of the settlement payment to emotional distress is neither reasonable nor consistent with the underlying realities of the claim. Instead, the portion of the settlement payment so allocated constitutes wages subject to FICA, FUTA and income tax withholding.

2. In the settlement agreement relating to Employee B's claim, the portion of the settlement payment allocated to attorney's fees and paid by the Employer directly to Employee B's attorney is includable in Employee B's income. However, the payment made to Employee B's attorney does not constitute wages subject to FICA, FUTA, and income tax withholding.

FACTS:

Two of the Employer's former employees, Employee A and Employee B, filed employment discrimination complaints against the Employer. Both Employee A and Employee B signed settlement agreements wherein they agreed to release all of their claims against the Employer in exchange for a sum of money to be paid to each employee by the Employer. Pursuant to the written settlement agreements, payments were made by the Employer to Employee A and Employee B in Year 1. The issue presented is what portion of the payments constitute wages subject to employment taxes. The pertinent facts are set forth below.

Employee A

Employee A filed charges of discrimination with the Equal Employment Opportunity Commission (EEOC). The charges were filed under Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000 et seq. (Title VII) and the Americans with Disabilities Act, 42 U.S.C. §§ 12101-12213 (ADA). Additionally, Employee A alleged violations of the Family and Medical Leave Act and breach of contract. In her complaint filed with the EEOC, Employee A alleged that Employer had discriminated against her by refusing to consider her complaints of disparate treatment based on her race and sex. Employee A further alleged that Employer had improperly revoked her short term disability status, and failed to accommodate her disability. Finally, Employee A claimed that Employer had retaliated against her for complaining about the discrimination, and for applying for benefits under the Employer's short term disability policy.

Employee A claimed injury and damages, including mental and emotional anguish and distress. Employee A asserted that Employer's treatment caused her to seek counseling and other medical assistance.

Employer and Employee A entered into a settlement agreement wherein it was agreed that Employer would pay the total sum of $ to Employee A in exchange for the release of any and all claims Employee A has or may have against the Employer pertaining to any event occurring up through the date of the settlement agreement. The settlement agreement was executed and the payment was made in Year 1.

In the settlement agreement, Employer and Employee A agreed to allocate one-half of the total payment, or $, to damages for lost wages. Employer reported this amount as wages on a Form W-2 issued to Employee A for Year 1. The parties agreed to allocate the remaining one-half of the total payment, or $, to alleged damages for personal injury and emotional distress. Employer reported this amount on a Form 1099 issued to Employee A for Year 1.

Employee B

Employee B filed charges of employment discrimination with the State Department of Human Rights and the EEOC alleging age discrimination under the State Human Rights Act and the Age Discrimination in Employment Act of 1967 (ADEA). Specifically, Employee B claimed that Employer had terminated his employment for unlawful reasons relating to age.

In his complaint filed with the State Department of Human Rights, Employee B alleged that he is over the age of Y, and that the reason given for termination of his employment was poor performance despite the fact that his performance was superior to that of a younger employee (under the age of Y) who was retained. In a letter from Employee B's attorney to Employer, it is stated that "[o]ur demand to settle this is $ including all lost income, bonus, 401K, Flex Savings, discount stock purchase, COBRA expenses and attorney fees."

Employer and Employee B entered into a settlement agreement wherein it was agreed that Employer would pay the total sum of $ to Employee B in exchange for the release of Employee B's claims against Employer. The settlement agreement stated that, "I have made allegations and charges that my Employer discriminated against me

on the basis of age. I further allege that I suffered emotional distress as a result of this termination." The settlement agreement was executed and the payment was made in Year 1.

In the settlement agreement, Employer and Employee B agreed to allocate $ to back pay. Employer reported this amount as wages on a Form W-2 issued to Employee B for Year 1. The parties further agreed that the remaining $ would be allocated to compensation for emotional distress that Employee B suffered as a result of the employment actions. Employer reported this amount on a Form 1099 issued to Employee A for Year 1. In addition, the settlement agreement provided that a lump sum payment in the amount of $ would be made to Employee B's attorney, and that the attorney would provide Employer with a Form W-9.

LAW AND ANALYSIS:

Settlement payments may be wages subject to employment taxes. The employment taxes that may apply include FICA, FUTA, and income tax withholding. FICA taxes, FUTA taxes, and income tax withholding are imposed on "wages" as defined in the Internal Revenue Code (the "Code"). For income tax withholding purposes, "wages" is broadly defined as "all remuneration for services performed by an employee for his employer," with specific exceptions (section 3401(a) of the Code). "Employment" for FICA and FUTA purposes means "any service, of whatever nature, performed by an employee for the person employing him....", again with specific exceptions. Code sections 3121(b); 3306(c).

Remuneration for employment, unless such remuneration is otherwise excluded, constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them. Section 31.3121(a)-1(i) of the Employment Tax Regulations. The Supreme Court has made plain that the term "remuneration for employment" is not limited to payments made for work actually performed but includes the entire employer-employee relationship for which compensation is paid by the employer to the employee. Social Sec. Bd. v. Nierotko, 327 U.S. 358, 365-366 (1946); See also Hemelt v. United States, 122 F.3d 204, 209-211 (4th Cir. 1997).

Under § 104(a)(2) of the Code, gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness. Section 104(a) also states as follows:

> For purposes of paragraph (a)(2), emotional distress is not treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress.

In order to exclude a settlement recovery from gross income under section 104(a)(2), a taxpayer must meet two independent tests. Construing a predecessor of section 104(a)(2), the Supreme Court enunciated the following requirements: first, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery was based on tort or tort type rights. And second, the taxpayer must show that the damages were received "on account of personal injuries or sickness." Schleier, 515 U.S. at 337. The 1996 amendment to the statute did not eliminate the second test for exclusion.

In the context of a settlement agreement, determining the exclusion from gross income depends on the nature of the claim which was the actual basis for the settlement, not the validity of the claim. Seay v. Commissioner, 58 T.C. 32, 37 (1972). The proper inquiry is **in lieu of what were damages awarded or paid.** Church v. Commissioner, 80 T.C. 1104, 1107 (1983); Delaney v. Commissioner, 99 F.3d 20, 23-24 (1st Cir. 1996); Fono v. Commissioner, 79 T.C. 680, 694 (1982), aff'd without pub. opinion, 749 F.2d 37 (9th Cir. 1984). Courts must consider all facts, including the allegations contained in the taxpayer's complaint, the evidence presented and the arguments made in the court proceeding and the intent of the payor. Threlkeld v. Commissioner, 87 T.C. 1294, 1306 (1986), aff'd, 848 F.2d 81 (6th Cir. 1988); Bent v. Commissioner, 87 T.C. 236, 245 (1986), aff'd, 835 F.2d 67 (3d Cir. 1987); Church v. Commissioner, supra.

The Service will allocate a lump sum payment using the best evidence available. This evidence may consist of the taxpayer's complaint requesting reasonable amounts of damages for each claim. Rev. Rul. 75-230, 1975-1 C.B. 93 and Rev. Rul. 85-98, 1985-2 C.B. 51 superseding Rev. Rul. 58-418, 1958-2 C.B. 18.

In the instant case, the parties to the settlement agreements have not asserted that any portion of the settlement payments is excludable from gross income under section 104(a)(2). Indeed, all of the payments made by Employer to Employee A and Employee B were included in their respective gross incomes, with some of the payments treated as wages, and others treated as non-wage income.[1] Thus, whether the payments are excludable from gross income under section 104(a)(2) is not at issue. Instead, the issue is whether it was appropriate to treat a portion of the settlement payments as non-wage income.

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[1] We note, however, that the payment made directly to Employee B's attorney by Employer was not included in Employee B's gross income. The appropriate tax treatment of this payment is discussed in detail below.

Notwithstanding, whether an amount is excludable under section 104(a)(2) serves as a beginning point in analyzing whether a settlement payment is wages for employment tax purposes. There is general agreement that to the extent damages are excludable from gross income under section 104(a)(2), they are not subject to employment taxes. See Temp. Reg. § 32.1. However, where, as here, the proceeds are includable in gross income, the entire amount or a portion of those proceeds may or may not be wages.

Whether an amount received in settlement of a dispute is remuneration for employment and subject to employment tax depends on the nature of the item for which the settlement amount is a substitute. See Alexander v. Internal Revenue Service, 72 F.3d 938, 942 (1st Cir. 1995) (the test for purposes of determining the character of a settlement payment for tax purposes "is not whether the action was one in tort or contract but rather the question to be asked is 'in lieu of what were the damages awarded?'") (citations omitted); Hort v. Commissioner, 313 U.S. 28 (1941) (holding that an amount received upon cancellation of a lease was a substitute for the rent which would have been paid under the lease and, thus, was taxable as ordinary income). Rev. Rul. 96-65, 1996-2 C.B. 6, holds that payments received by an individual in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the Civil Rights Act of 1964 are both income and wages. In addition, the ruling concludes that payments received for emotional distress in satisfaction of such a claim are not excludable from gross income under section 104(a)(2), except to the extent they are damages paid for medical care (as described in section 213(d)(1)(A) and (B)) due to emotional distress.

Each of the settlement agreements executed in the instant case contains a specific allocation among various claims. The settlement agreement between Employer and Employee A allocated one-half of the total payment to lost wages, and the remaining half to damages for personal injury and emotional distress. The settlement agreement between Employer and Employee B allocated one-third of the total payment to back pay, and the remaining two-thirds to damages for emotional distress.

The Service is not necessarily bound by the allocations contained in settlement agreements to which it was not a party. See Robinson v. Commissioner, 102 T.C. 116 (1994), rev'd in part on other grounds, 70 F.3d 34 (5th Cir. 1995), cert. denied 519 U.S. 824 (1996). The allocation among the various claims of the settlement can be challenged where the facts and circumstances indicate that the allocation does not reflect the economic substance of the settlement. See Phoenix Coal Company, Inc. v. Commissioner, 231 F.2d 420 (2d Cir. 1956); Bagley v. Commissioner, 105 T.C. 396 (1995), aff'd, 121 F.3d 393 (8th Cir. 1997). See also Hemelt, supra, 122 F.3d at 208 (characterization of settlement proceeds cannot depend entirely on the intent of the parties).

LeFleur v. Commissioner, T.C. Memo. 1997-312 addresses the reallocation issue in a case involving claims for breach of contract, emotional distress, and punitive damages. In an out-of-court written settlement, the payment was allocated $200,000 to contract, $800,000 to emotional distress, and $0 to punitive damages. The taxpayer excluded the $800,000 from income under section 104(a)(2). The Service disregarded the terms of the written settlement agreement and reallocated the $800,000 to contract/punitive damages. The Tax Court upheld the IRS reallocation. Referring to the settlement, the court stated that "the allocation did not accurately reflect the realities of the petitioner's underlying claims." In determining that the $800,000 was not excludable under section 104(a)(2), the court stated:

> "In light of the facts and circumstances, we conclude that petitioner suffered no injury to his health that could be attributed to the actions of the defendants, and we are not persuaded that such injury was the basis of any payment to him by Blount."

In Robinson v. Commissioner, supra, the taxpayer filed a lawsuit against a bank alleging that the defendant failed improperly to release a lien on his property. The jury awarded taxpayer approximately $60 million including $6 million for lost profits, $1.5 million for mental anguish and $50 million for punitive damages. The parties agreed to settle the lawsuit for approximately $10.7 million, of which, taxpayer unilaterally allocated 95 percent to tortlike personal injuries. The trial judge entered a final judgment in accordance with the terms of the settlement agreement. The Commissioner determined only 5 percent of the settlement proceeds should be allocated to excludable personal injury damages because the final judgment did not reflect accurately the underlying settlement and the trial court did not independently review the allocation contained therein.

The Tax Court held that the allocation in a settlement is generally binding for tax purposes to the extent that the agreement is entered into by the parties in an adversarial context, at arm's length, and in good faith. Citing Threlkeld, 87 T.C. at 1306-1307; Fono v. Commissioner, 79 T.C. at 680, 694 (1982), aff'd without pub. opinion, 749 F.2d 37 (9th Cir. 1984); and Mitchell v. Commissioner, T.C. Memo. 1990-617, aff'd, 992 F.2d 1219 (9th Cir. 1993). The court held although the parties were

adversarial with respect to the dollar amount they were not adversarial on the issue of the allocation. Accordingly, the court concluded neither the Service nor the federal courts were bound by the allocation contained in the final judgment.[2]

Additionally, the proper characterization i.e. tort or nontort, of a settlement payment will depend in part on the types of remedies that are available for the asserted claim against the employer. For example, a broad range of remedies, including back pay and compensatory damages, are available for claims brought under Title VII, as amended (proscribing, inter alia, gender and race discrimination), whereas under the Employee Retirement Income Security Act (ERISA), the available remedies are narrow and compensatory damages are not available. Mertens v. Hewitt Associates, 508 U.S. 248 (1993). If the claim is brought under state law, the nature of the remedies available determines whether the claim sounds in tort.

Employee A

Employee A asserted her claim under Title VII and the ADA. Title VII allows for the recovery of back pay, compensatory and punitive damages, and attorney's fees. The ADA employs the same remedial scheme as Title VII, as amended in 1991. See 42 U.S.C. § 12213.

As noted above, half of the settlement payments made to Employee A were allocated to back wages, with the remaining half allocated to emotional distress. Employee A's underlying claim i.e., that she was subjected to discriminatory treatment by her employer, is a wage-based claim. However, Employee A also claimed damages related to emotional distress, a tort-based claim Our review of the information provided indicates that Employee A exhibited symptoms of emotional distress, and that she sought medical and psychiatric treatment as a result of the Employer's alleged discrimination. Moreover, there is no question that the Employer was apprised of these symptoms and treatment at the time the settlement was executed. We conclude that the Employer intended to compensate Employee A for these personal injuries and that the allocation accurately reflects the realities of Employee A's underlying claims.

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[2] Compare McKay v. Commissioner, 102 T.C. 465 (1994), rev'd and rem'd per curiam on other grounds, No. 94-41189 (5th Cir. April 10, 1996).

Accordingly, we hold that the allocation was reasonable. We conclude that because the payments allocated to emotional distress do not constitute remuneration for services, they are not wages subject to employment taxes.[3]

Employee B

Employee B asserted his claim under the State Human Rights Act, and the ADEA. The ADEA allows for the recovery of back pay, front pay, liquidated damages and attorneys' fees. The State Human Rights Act allows for the recovery of compensatory damages and attorneys' fees, including damages for emotional distress.

As noted above, one-third of the settlement payment made to Employee B was allocated to back wages, with the remaining two-thirds allocated to emotional distress. The underlying documents that have been made available to us establish that in his complaint, Employee B requested damages for economic injuries, and did not seek damages for emotional distress or other personal injury. The underlying documents all focus on Employee B's allegation that his employment was unjustly terminated as a result of age discrimination. In fact, the only reference to emotional distress that we have found is limited to a single statement in the settlement agreement signed by Employee B: "I further allege that I suffered emotional distress as the result of this termination." The information provided to us contains absolutely no indication that Employee B suffered any symptoms of emotional distress or sought treatment of any kind. A letter from Employee B's attorney states Employee B would be willing to settle the claim for the sum of "$, including all lost income, bonus, 401K, Flex Savings, discount stock purchase, COBRA expenses and attorney fees." There is no mention made of emotional distress in this letter, or anywhere else in Employee B's claim. Thus, it seems clear that Employee B was seeking an award of back pay to compensate him for remuneration that would have been received up to the time of the settlement but for the employer's wrongful conduct.

Under these circumstances, we see no factual basis for allocating two-thirds of the total amount paid to Employee B to emotional distress. In our view, this is a situation where the allocation does not reflect the economic substance of the settlement and does not reflect the realities of the underlying claim. Moreover, we note that the parties were not adversarial with respect to the allocation, as both parties would benefit from characterizing the bulk of the settlement to emotional distress and thereby avoiding liability for employment taxes that would be owed if the payments were properly characterized as back wages. Accordingly, we conclude that the proper

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[3] Employee A may be permitted to exclude from gross income the portion of the emotional distress damages that do not exceed the amounts Employee A paid for medical care (as described in section 213(d)(1)(A) and (B)) that were attributable to Employee A's emotional distress, if Employee A was not allowed a federal income tax deduction for those expenses. See § 104(a).

characterization of one hundred percent of the settlement payments made to Employee B is wages subject to employment taxes.

Attorney's Fees

It is the position of the IRS that proceeds of a settlement which would be includable in the taxpayer's income if paid directly to the taxpayer, and which are instead paid to a taxpayer's attorney pursuant to a contingent fee agreement are income to the taxpayer. See e.g., Kenseth v. Commissioner, 259 F.3d 881 (7th Cir. 2001); Young v. Commissioner, 240 F.3d 369 (4th Cir. 2001); Coady v. Commissioner, 213 F.3d 1187 (9th Cir. 2000); O'Brien v. Commissioner, 319 F.2d 532 (3d Cir. 1963).

The Courts of Appeals are divided on this question. Prior to the split to form the Eleventh Circuit, the Court of Appeals for the Fifth Circuit, in Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959), held that an attorney's lien under Alabama law provided the attorney with a property right in the lawsuit. Therefore, the court held that the proceeds paid directly to the attorney pursuant to a contingent fee agreement constituted the attorney's property and were not income to the taxpayer. Because the identical Alabama statute was involved, the Eleventh Circuit followed Cotnam in Davis v. Commissioner, 210 F.3d 1346 (11th Cir. 2000). Reasoning that it was bound thereby, the Court of Appeals for the Fifth Circuit extended Cotnam to all cases within its jurisdiction. Srivastava v. Commissioner, 220 F.3d 353 (5th Cir. 2000). The Court of Appeals for the Sixth Circuit, on a somewhat different theory, held that a Michigan taxpayer may exclude from gross income the portion of an interest award that is paid to an attorney under a contingent fee agreement. The Court reasoned that a contingent fee agreement constitutes a division of property rather than an anticipatory assignment of income already earned. Estate of Clarks ex rel. Brisco-Whitter v. United States, 202 F.3d 854 (6th Cir. 2000).

As noted above, a lump sum payment in the amount of $ was made directly to Employee B's attorney pursuant to the settlement agreement. The amount paid to Employee B's attorney was not included in Employee's B's income, and no Form 1099 was issued to Employee B reporting the payment. We agree with Kenseth, Coady, and Young, and similar cases and therefore rule that the $ in settlement proceeds that was paid directly to Employee B's attorney must be included in Employee B's gross income. We note that Employee B was a resident of the Seventh Circuit (which decided Kenseth) when he filed his claim against Employer.

We next consider whether the $ payment to Employee B's attorney is wages for employment tax purposes. Revenue Ruling 80-364, 1980-2 C.B. 294, considers whether legal fees and interest received in connection with claims for back pay are wages for employment tax purposes. The ruling describes three situations.

In Situation 1, after termination of employment by a company, an individual filed a complaint for back pay. The court awarded the individual $8X in back pay, $1X in attorney's fees, and $1X in interest. The ruling holds that although the entire $10K is includible in gross income, only the back pay award of $8X is wages for federal employment tax purposes.

In Situation 2, an individual sues the individual's employer for $15X for back pay. Pursuant to a court order the employer paid the individual $10X. The court order did not indicate that a portion of the award was for attorney's fees or interest. The employee paid $1X in attorney's fees. The ruling holds that the full amount of the award is income to the employee and is also wages for federal employment tax purposes.

In Situation 3, a union files a claim for breach of a collective bargaining agreement on behalf of its members against a company. The union and the company entered into a settlement agreement, later approved by a district court, which provided that the company would pay the union $40X in settlement of all claims. The union paid $6X of the settlement for attorney's fees and returned $34X dollars to the employees for back pay owed to them. The back pay was distributed to the employees in proportion to their claims. The ruling holds that the amount paid by the union in attorney's fees is not remuneration for employment and thus is not wages. In addition, the attorney's fees are not includible in the employees' gross income.

A court award of attorney's fees under a fee shifting statute is not wages under the reasoning in Rev. Rul. 80-364. Employee B's claim was filed under the ADEA. The ADEA statute provides for the recovery of attorneys' fees in addition to compensatory and liquidated damages. See 29 U.S.C. § 626(b) (referencing and incorporating the remedies in the Fair Labor Standards Act (FLSA), 29 U.S.C. § 216). ADEA specifically incorporates the FLSA remedies found in 29 U.S.C. § 216, including the recovery of attorneys' fees. Under 29 U.S.C. § 216(b), "The court in such action shall, in addition to any judgment awarded to the plaintiff or plaintiffs, allow a reasonable attorney's fee to be paid by the defendant and costs of the action." If, instead of entering into a settlement agreement, Employee B had prevailed in litigation of his claim under ADEA, he would have received an award of attorney's fees in addition to and separately from the back wages award. Employer has represented that the $ allocated to attorneys' fees represents the amount of expenses incurred by Employee B by reason

of the claims filed against Employer and the settlement agreement. Accordingly, we conclude that the amount of $ paid under the agreement is not wages for federal employment tax purposes.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.